MCI

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92-101

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July 1, 1992

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Donna Searcy
Secretary
Federal Communications Commission
Room 222
1919 M Street, NW
Washington, D.C. 20554

Re: In the Matter of Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions", CC Docket No. 92-101, Bell Atlantic Tariff F.C.C. No. 1, Transmittal No. 497; US West Tariff F.C.C. Nos. 1 and 4, Transmittal No. 246; Pacific Bell Tariff F.C.C. No. 128, Transmittal No. 1579.

Dear Ms. Searcy,

Enclosed herewith for filing are the original and seven (7) copies of MCI Telecommunications Corporation's Petition to Reject in the above captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI Petition furnished for such purpose and remit same to the bearer.

Yours truly,

Michael F. Hydock

Michael F. Hydock
Senior Staff Member
Federal Regulatory Affairs

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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Pacific Bell Tariff F.C.C. No. 128	) Transmittal No. 1579

Opposition to Direct Cases

MCI TELECOMMUNICATIONS CORPORATION
1133 19TH STREET, N.W.
WASHINGTON, D.C. 20036

July 1, 1992

TABLE OF CONTENTS

SUMMARY iv.

BACKGROUND OF THE ISSUE 3

I. Have the LECs borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change under the Commission's price cap rules? 5

SFAS-106 COSTS ARE NOT EXOGENOUS 6

THE IMPACT OF THE ACCOUNTING CHANGE IS NOT EXOGENOUS 7

THE LECs HAVE NOT ADEQUATELY ADDRESSED THE EXPECTED ASSET ACCRUAL 10

PRICE CAP ADJUSTMENTS DUE TO SFAS-106 WOULD RESULT IN DOUBLE RECOVERY ABSENT ADJUSTMENTS REGARDING THE CURRENT RATE OF RETURN 11

II. If these cost changes are treated as exogenous,

(a) Should costs associated with implementation of SFAS-106 prior to January 1, 1993 (when the accounting change becomes mandatory) be treated as exogenous? 17

(c) Given these assumptions, have the individual LECs correctly computed the exogenous cost changes? 18

¶ 11. (5) all studies on which the LEC seeks to rely in its demonstration that these accounting changes should be considered exogenous cost changes, including all studies demonstrating that the change is not reflected in the current price cap formulas, factors for inflation, productivity, allowed exogenous changes, initial price cap rates, and the sharing and low-end formula adjustment mechanisms; 20

THE STUDIES ARE INHERENTLY CONTRADICTORY 21

NEITHER STUDY ADDRESSES THE LOW-END ADJUSTMENT FORMULA 23

ISSUES WITH THE USTA STUDY 24

¶ 13. (5) what type and level of SFAS-106 type expense is reflected in current rates; 26

¶ 13. (6) what type and level of SFAS-106 type expense was reflected in the starting rates for price caps; 26

¶ 14. Descriptions and justifications of the actuarial assumptions, and the assumptions unique to postretirement health care benefits, made in computing the SFAS-106 expenses. These assumptions should include, but are not limited to, the time value of money, participation rates, retirement age, per capita claims costs by age, health care cost trend rates, Medicare reimbursement rates, salary progression (if a company has a pay related plan), and the probability of payment (turnover, dependency status, mortality, etc.) Parties and commenters should also discuss what assumptions, if any, were made about future events such as capping or elimination of benefits, or the possible advent of national health insurance. 27

¶ 15. Further, since part of the growth in the GNP-PI presumably occurs due to growth in medical costs, we seek information on what adjustment, if any, should be made in the exogenous adjustment to avoid any double counting. If any adjustment has been made, parties and commenters should document how the adjustment was computed. Moreover, parties and commenters should describe and quantify any wage changes which will be reflected in the GNP-PI that are expected to occur as a result of the introduction of SFAS-106. In particular, parties and commenters should discuss what adjustment, if any, should be reflected in the exogenous adjustment for this change. 29

¶ 16. Finally, parties and commenters, relying on the macroeconomic model used in the USTA study should fully describe and document the model, including a method of estimation, parameter estimates, and summary statistics. This same data should be submitted for any alternate functional forms which were modeled, including data used to estimate the model, the data used in making forecasts from the model, and the results of any sensitivity analyses performed to determine the effect of using different assumptions. 31

CONCLUSION 33

APPENDIX A

SUMMARY

MCI Telecommunications Corporation (MCI) herein replies to the Direct Cases filed by the Price Cap Local Exchange Companies (LECs) subject to an Order of Investigation and Suspension issued by the Common Carrier Bureau. On or before June 1, 1992 all LECs subject to Price Cap regulation filed Direct Cases in this proceeding attempting to justify exogenous cost treatment for accounting costs associated with Statement of Financial Accounting Standards No. 106 (SFAS-106). SFAS-106 requires all firms to recognize, through accrual accounting, the costs associated with the provision of Other Post-retirement Benefits (OPEBs) in the year in which employees earn these benefits.

MCI demonstrates that the Direct Cases of the LECs fall short of the burden placed upon them in proving that SFAS-106 costs should be afforded exogenous treatment. In particular, MCI provides evidence, through the Affadavit of Professor Allan Drazen, that the current rate of return contemplated these costs, and to allow exogenous treatment of the costs at this time would amount to an additional level of double recovery. Further, MCI illustrates the simultaneity of both wage and benefit expenses to these companies. This simultaneity precludes the treatment of one form of labor compensation, SFAS-106 related costs, as exogenous and the other as endogenous. To treat SFAS-106 costs as exogenous would introduce an element of asymmetry the price cap regulation.

Also, MCI points out technical shortcomings of the Direct Cases and their supporting studies. Most important of these is the failure to recognize and account for double counting within the GNP-PI and the medical care inflation rates inherent in the SFAS-106 obligations calculated by the carriers. Additionally, both studies submitted by the LECs use overly

simplistic and naive models to estimate the impacts of SFAS-106 on the GNP-PI. Notwithstanding the limitations of the structure of these models, MCI demonstrates that the data inputs used in these models are suspect. Such failures illustrate the inadequacy of the methodologies proposed by the carriers to support their positions.

MCI respectfully asks the Commission to deny exogenous treatment for the SFAS-106 costs that are part and parcel of labor compensation. Failure to do so would disrupt the incentives under the price cap structure of regulation. If, however, the Commission does find that these costs are exogenous, these estimates provided by the LECs must be reduced to account for the double recovery in the current rate of return and the double counting between the SFAS-106 liability estimates and the medical care cost inflation within the GNP-PI. Furthermore, the Commission must mandate a standard set of actuarial assumptions, econometric models, and reporting structures to insure that access ratepayers can review the proposed costs, as well as review the year-by-year true-ups to those costs. Additionally, the methodology of computing the double counting within the GNP-PI must be drastically improved before these costs can be reviewed.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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Opposition to Direct Cases

MCI Telecommunications Corporation (MCI) herein replies to the Direct Cases filed by the Price Cap Local Exchange Companies (LECs) subject to an Order of Investigation and Suspension issued by the Common Carrier Bureau.[1] On or before June 1, 1992 all

[1]In the Matter of Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions", CC Docket No. 92-101, Bell Atlantic Tariff F.C.C. No. 1, Transmittal No. 497; US West Tariff F.C.C. Nos. 1 and 4, Transmittal No. 246; Pacific Bell Tariff F.C.C. No. 128, Transmittal No. 1579, Order of Investigation and Suspension (Order), released April 30, 1992, DA 92-540.

LECs subject to Price Cap regulation[2] filed Direct Cases in this proceeding attempting to justify exogenous cost treatment for accounting costs associated with Statement of Financial Accounting Standards No. 106 (SFAS-106). MCI establishes below that the Direct Cases of the LECs fall short of the burden placed upon them in proving that SFAS-106 costs should be afforded exogenous treatment. In particular, MCI demonstrates that the current rate of return contemplated these costs, and to allow exogenous treatment of the costs at this time would amount to an additional level of double recovery. Further, MCI illustrates the simultaneity of both wage and benefit expenses to these companies. This simultaneity precludes the treatment of one form of labor compensation, SFAS-106 related costs, as exogenous and the other as endogenous. Finally, MCI points out technical shortcomings of the Direct Cases and their supporting studies. Most important of these is the failure to recognize and account for double counting within the GNP-PI and the medical care inflation rates inherent in the SFAS-106 obligations calculated by the carriers. Also, both studies submitted by the LECs use overly simplistic and naive models to estimate the impacts of SFAS-106 on the GNP-PI. Such failures illustrate the inadequacy of the methodologies proposed by the carriers to support their positions.

Within this Opposition, MCI will discuss the errors contained in the LEC Direct Cases as they correspond to the questions raised by the Commission in its Order. First, a summary of the SFAS-106 issue before the Commission will be presented. Subsequent to

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[2]The following LECs were named parties to this proceeding and filed Direct Cases: Ameritech Operating Companies (Ameritech), Bell Atlantic Telephone Companies (BAT), BellSouth Telecommunications, Inc. (BST), GTE Telephone Operating Companies (GTE), Nevada Bell and Pacific Bell (PacBell), NYNEX Telephone Companies (NYNEX), Rochester Telephone Company (RTC), Southern New England Telephone Company (SNET), Southwestern Bell Telephone Company (SWB), United Telephone Systems (UTS), and US West Communications Inc. (USWC).

that summary will be a discussion of the issues raised by the LEC submissions to this Order, following the structure of the investigative questions and material requested to be presented. MCI will only address those key elements that serve as the critical points of the LEC arguments, not all the questions raised by the Commission.

BACKGROUND OF THE ISSUE

The filing LECs are attempting to raise their price cap indices to adjust for presumed exogenous costs associated with postretirement health benefit costs. As early as 1979, the Financial Accounting Standards Board (FASB) began an examination of the appropriate method of accounting for Other Postretirement Employee Benefits (OPEB). After initially determining that the examination of OPEB should be joined with an examination of pension plans, the FASB concluded in 1984 that OPEB should be separated out. Now, with the proposal of Statement of Financial Accounting Standards No. 106 (SFAS-106) in February 1989 and its issuance in December of 1990[3], the FASB has determined that both pension and other benefits should be handled in a consistent accounting framework.

Under SFAS-106, companies must adopt a new accounting treatment for OPEB costs for fiscal years beginning after December 15, 1992. Under the new guidelines, companies are required to convert from a cash-basis method of accounting and reporting OPEB costs to an accrual method. Prior to the proposed accrual method, companies reflected the "pay as you go" costs of postretirement benefits and expenses associated with these benefits in their income statements. Under SFAS-106, companies now must make accrual adjustments

[3]Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 106: Employers' Accounting for Postretirement Benefits Other Than Pensions, 1990.

to their financial statements to reflect the expected accrued cost of postretirement benefits "earned" by their current work force in any given year.

With this change in accounting practices, two components of the new practices must be recognized by companies that offer OPEB: the going-forward accrual of expected OPEB costs of the work force in place during the reporting year in question; and, the treatment of the underfunded liability for benefits earned under a company's OPEB prior to the effective date of SFAS-106. This latter component can be recognized either as a one-time adjustment, or can be amortized over a period of twenty or more years.

Late in 1991, the Commission approved the requests of two Local Exchange Companies (LECs) to institute SFAS-106 type accounting for OPEB.[4] In that SFAS-106 Order, the Common Carrier Bureau indicated that Commission had decided that such accounting treatment would not conflict with its regulatory objectives. Furthermore, the Bureau decided that a flash cut accounting treatment of the underfunded liability for the period prior to SFAS-106 accounting would be detrimental to the carriers' operating results. Therefore, carriers were directed to use a twenty year deferral and amortization procedure for this portion of the SFAS-106 costs. Finally, the Bureau authorized all subject carriers to implement SFAS-106 on or before January 1, 1993, but did not authorize exogenous treatment of these costs for ratemaking purposes.

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[4] In the Matter of Southwestern Bell and GTE Service Corporation Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, SFAS-106 Order, released December 26, 1991, DA 91-1582.

I. Have the LECs borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change under the Commission's price cap rules?

In their Direct Cases, the price cap LECs unanimously contend that the costs associated with SFAS-106 are not embedded in their rates or in their price cap indices.[5] They argue that exogenous treatment should be furnished for the following reasons: 1) The accounting change is outside of the control of the LEC; 2) The change is compatible with regulatory accounting needs and is approved; and, 3) The impact of SFAS-106 will not be double counted in the GNP-PI factor of the Price Cap formula because of adjustments each carrier makes to the level of exogenous costs proposed to be included in the proposed price cap index. This latter adjustment is supported through separate studies performed for the United States Telephone Association (USTA) and the National Economic Research Associates, Inc. (NERA) and submitted with the LEC Direct Cases.[6]

MCI demonstrates herein that requirements for exogenous treatment of SFAS-106 costs has not been sufficiently met for items 1) and 3) above. The Commission has clearly indicated that carriers have the "burden of demonstrating that no double-counting would result from exogenous treatment, even if the carriers demonstrate that the costs are beyond their control."[7] MCI shows below that the supposed "exogenous" costs of SFAS-106 are intrinsically tied to all other endogenous labor costs and it is futile to attempt to disconnect OPEB costs from other labor costs for exogenous treatment. Furthermore, none of the

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[5]Several LECs do admit that certain VEBA-type assets are reflected in their current rates. See, for example, BellSouth's Direct Case.

[6]The NERA study was submitted as supporting documentation by Pacific Bell in its Direct Case, and concurred in by Rochester. The remainder of the LECs utilize the USTA study.

[7]Order, ¶ 6.

LECs address the issue that the initial price cap rates have embedded in them at least some level of the SFAS-106 costs. MCI illustrates below how the cost of equity component of the authorized rate of return has been encumbered with some of these costs, introducing yet another level of double-counting that is not addressed by the LECs. Taken together, these issues raise serious doubts concerning the appropriateness of treating SFAS-106 costs as exogenous, as well as casting doubts on the magnitude of the LECs estimates.

SFAS-106 COSTS ARE NOT EXOGENOUS

Notwithstanding the issue of double recovery of the SFAS-106 costs relative to the prescribed rate of return to be discussed below, there are other grounds for the Commission to reject the treatment of SFAS-106 costs as exogenous. Most critical of these reasons is the fact that OPEB plans and other forms of compensation are interrelated. A firm will generally decide upon the total amount of compensation it is willing to offer its employees, and has great latitude in mixing the components of the package (cash wages, OPEB, pensions, current benefits, etc.). If exogenous treatment is afforded to one portion of the compensation package, an asymmetrical relationship will be afforded carriers under price caps. This will allow carriers to offer increased OPEB, for which they would receive exogenous treatment, and decrease other forms of compensation.[8] This latter decrease will allow carriers to increase the earnings they could potentially keep under the price cap sharing rules. The interrelationships of labor compensation components are so complex as to preclude any reasonable method of tracking and adjusting for the costs of SFAS-106

[8] In fact, the USTA study itself predicts a similar situation where SFAS-106 costs increase, the wage rate in the economy will fall, offsetting the increase in labor costs associated with SFAS-106.

in exogenous filings as the initial set of variables changes. Both sets of rules, SFAS-106 as well as the price cap rules would require these carriers to re-estimate their liabilities under SFAS-106 and to flow these changes through to their price cap indices in true-up filings.

THE IMPACT OF THE ACCOUNTING CHANGE IS NOT EXOGENOUS

In its development of a price cap method of regulation for the LECs, the Commission correctly realized the need to allow the price cap indices to be adjusted upward or downward for some, but not all, costs that are outside of the carrier's control.[9] In its discussions of exogenous and endogenous costs, the Commission has verified that certain costs triggered by legislative, judicial, or regulatory decisions are indeed exogenous (eg., separations changes, reallocation of regulated and non-regulated costs, expiration of amortizations, etc.).[10] At the same time, however, the Commission has also viewed certain costs that stem from legislative, judicial, and regulatory decisions as endogenous (depreciation rate changes, most tax law changes). Furthermore, the Commission explicitly reserved the right to decide whether SFAS-106 costs would be considered exogenous.[11]

The price cap LECs assume that SFAS-106 costs should be afforded exogenous treatment because the change in the accounting standards is outside of the companies'

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[9]See, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. at 3187, ¶ 645; and Second Report and Order, CC Docket No. 87-313, released October 4, 1990, ¶ 166.

[10]In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC docket No. 87-313, Order on Reconsideration, released April 17, 1991, ¶ 58-85.

[11]Ibid., ¶ 59-63.

control. While this lack of control over the FASB ruling is apparent, the LECs make no case as to why the effect of SFAS-106 is exogenous, and outside of their control. In fact, SFAS-106 is nothing more than an accounting change that alters the temporal recognition of costs on financial statements. It does not, by itself, alter the underlying costs of providing telephone service, but rather formally recognizes costs already being incurred by the LECs. The provision of OPEBs is not mandated, but rather the accounting treatment of these costs is promulgated by FASB.

The LECs, through their own evaluations on the productivity of their labor force, their own decisions to deploy certain amounts of labor and capital resources, and their own decisions as to how much each is worth to the corporation, have endogenously determined the amount of compensation to offer their employees. In this management process, the LECs have also determined the relative mix of wages and benefits to be offered to those employees. The amount of OPEB offered to its employees was an integral part of its management of the costs of its labor force. Both the level of wages, and the corresponding level of benefits, including OPEB, were simultaneously decided upon by price cap LEC management teams.

As such, the exogenous treatment of SFAS-106 costs is no more desirable than exogenous treatment of any other labor cost for these firms. Price cap LECs are able to reduce labor force expenses through a variety of means. Future wage increases can be minimized, pension benefits can be altered, benefit levels reduced. It is doubtful that any price cap LEC would approach the Commission seeking exogenous cost increases for wage increases. Yet wage increases or decreases are directly related to the level of benefits offered by theses firms. To allow these LECs to flow through OPEB plan costs would defeat the stated goals of achieving efficiency under price caps, and would mark a return to the experience of rate of return regulation. Price cap LECs were given generous incentives to achieve higher than otherwise rates of return if they performed efficiently. Granting exogenous treatment for these benefit plans would only advance asymmetrical treatment within price caps. Ratepayers would pay the increased costs of these programs, while LECs could turn around and reduce or hold constant over time the wages paid to their employees, thus gaining a higher rate of return. In fact, data from the USTA Report suggests that the LECs have been extremely generous in their OPEB plans, offering benefit levels that are nearly twice the level of non-LEC plans. Therefore, LEC's could use the leverage of these plans to trim or eliminate future wage increases. One of the LEC parties to this proceeding, Bell Atlantic, goes so far as to admit that it seeks exogenous treatment for SFAS-106 costs, and that it could reduce wages to offset the expense. Furthermore, it states that it would not feel compelled to offset its exogenous costs of SFAS-106 with any wage-related savings it could obtain.[12]

The filing LECs will doubtlessly contend that the USTA study supporting their position considers a fall in the wage rate that is triggered by SFAS-106 costs in the economy. The amount being filed for exogenous treatment has been reduced to account for this change in the aggregate wage rate.[13] In a theoretical sense this impact is similar to the discussion above. However, what is not addressed by the USTA study is the year

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[12]Bell Atlantic Direct Case, p. 27-8.

[13]USTA Report, p. 5. The wage rate under the simulation decreases by 0.93 percent.

by year dynamics of the potential for OPEB compensation to substitute for cash compensation. The study addresses a one-time shift, not the continuing ability of the LECs to trigger exogenous SFAS-106 costs. Further, the LEC estimate is one global reduction for the U.S. economy as a whole. The price cap LECs would be perversely incented to reduce the cash wage rate by more than this amount since they could increase their earnings, while recovering the costs of the substitute through the exogenous SFAS-106 adjustment. No evidence is suggested by the study that the LECs would be constrained to the same percent reduction in the wage rate. In fact, just the opposite would result, since by the study's own findings, the increased national costs from SFAS-106 that drive the national wage rate reduction are less than half the amount of the LEC impact.

THE LECs HAVE NOT ADEQUATELY ADDRESSED THE EXPECTED ASSET ACCRUAL

The LECs and their shareholders would enjoy a windfall gain of cash if exogenous treatment were given to SFAS-106 costs. Since the accrual of these costs is occurring several decades before the expected disbursement of these funds, LECs would enjoy the use of ratepayer funds used to cover these accruals. The implementation of SFAS-106 does not change the economic costs of providing interstate telecommunications services. Rather it enforces certain accounting conventions on the LECs. The LECs, under their proposals, would increase their present cash flows to cover expected expenses far in the future. As such, they would have use of large amounts of funds and the uses of such cash would be hard for ratepayers to track. The Commission must therefore reject this attempt to manipulate the price cap rules to minimize risk while maximizing earnings.[14]

PRICE CAP INCREASES DUE TO SFAS-106 WOULD RESULT IN DOUBLE RECOVERY ABSENT ADJUSTMENTS REGARDING THE CURRENT RATE OF RETURN

The LECs attempt to define the double-counting issue of SFAS-106 costs solely within the context of the effect on the GNP-PI. Essentially by doing so, they argue that the costs associated with SFAS-106 are entirely new, and therefore qualify to be considered for exogenous treatment within the Price Cap rules. According to the Commission's rules, exogenous costs that would be reflected wholly or partially in the GNP-PI must be adjusted by that impact before being included as exogenous costs.

In the case of SFAS-106 costs, however, the GNP-PI double counting issue is not the only double counting that is relevant. Rather the issue is whether the costs associated with OPEB and SFAS-106 have already been accounted for in the context of the represcription of the interstate rate of return (ROR).[15] Herein, MCI demonstrates that LECs, as well as

[14]In the event that the Commission does find that these costs should be afforded exogenous treatment, the Commission must also entertain the possibility of providing special reporting mechanisms for these flows and the resulting assets. As discussed elsewhere in this Opposition, the parameters surrounding the evaluation of the transitional obligation as well as the "in-year" obligation will differ from actual values (eg., the number of employees covered by OPEBs may be reduced through work force reductions or reductions in benefits). This will necessitate true-up filings on a yearly basis. The tracking and review of the changes in the accruals, as well as the total asset values of the plans, would be required to ascertain whether the rates implied by these charges are just and reasonable. The special reporting structures could take the form of revised Tariff Review Plan data, as well as revised ARMIS reports. Furthermore, the assets within the funds should be earmarked for OPEBs, and not be allowed for any other use other than what ratepayers are paying for under these SFAS-106 costs.

[15]See, In the Matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order (ROR Order), 5 FCC Rcd No. 25; and Memorandum Opinion and Order (ROR Recon Order), released December 6, 1991.

their shareholders, have already been at least partially compensated for the costs associated with the accrual of SFAS-106 costs. The attached affidavit by Professor Allan Drazen (Appendix A) illustrates that the cost of equity as calculated during the recent rate of return represcription has already captured the costs of SFAS-106, and any additional amounts awarded to the LECs for this accounting change would result in some double recovery of these costs.[16] The analysis presented herein suggests that some significant portion of SFAS-106 costs has already been captured by the cost of equity calculation within the rate of return proceeding, and it is incumbent upon the LECs to quantify this amount and reduce their corresponding SFAS-106 costs for which they desire exogenous treatment. None of the LECs have performed this analysis within their Direct Cases, so the amounts proposed by the LECs for exogenous cost treatment should be rejected at this time.

In the course of the ROR proceeding, the Commission determined a cost of equity based upon a "classical" discounted cash flow (DCF) model.[17] Together with the cost of debt, the Commission determined an appropriate rate of return for the provision of interstate services of the LECs. Therefore, any costs affecting the LECs cost of capital has already been embedded in the existing rate of return, and any attempt to include these costs again would result in double recovery of those costs.

To determine the LEC cost of equity, the Commission employed a DCF model, using data from the Regional Bell Operating Companies (RBOCs). The DCF model relates the

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[16]See, Exhibit A, Affidavit of Professor Allan Drazen (Drazen Affidavit).

[17]ROR Order, ¶ 38-39.

cost of equity to a formula comprised of the annual dividends expected for the next year, the current share price, and a consensus of the long-term expected growth by the Institutional Brokers Estimate System (IBES). The Commission utilized the monthly average share prices for the period January 1990 through July 1990 to populate the model.[18]

The rationale behind the DCF model as it is used to determine the cost of equity for a firm is the idea that the equity markets work in an efficient manner. That is, the market participants (investors, brokers, market analysts) all react to information that determines the profitability of the firm. All information concerning that firm's current and prospective earnings is embedded into the market price for that firm's equity, or stock price. Therefore, the firm's share price reflects the present value of the current and future cash flows expected by the holders of the firm's stock. The Commission, in the ROR Order, reconfirmed the viability of this concept, and in fact discussed the mechanics of the market's perception of anticipation and discounting of occurrences that would impact the future earnings of a firm.[19]

Therefore, the issue remains whether the costs associated with OPEB, as well as any market reaction to these SFAS-106 costs, have already been embedded in the data used to derive the current rate of return for interstate services. The Drazen Affidavit demonstrates that not only were the implicit costs associated with OPEB already recognized by the market and captured within share prices far in advance of the rate of return proceeding,

[18]ROR Order, ¶ 38-39.

[19]ROR Order, ¶ 116, 118.

but also the impacts from SFAS-106 accounting treatment were also reflected in the cost of equity used by the Commission to determine the represcribed rate of return. Therefore, exogenous treatment of SFAS-106 costs would amount to double recovery.

RBOC stocks are among the most widely held stocks in the country, and consequently, the earnings of these companies are scrutinized and researched by the major brokerage houses, as well as many of the mutual funds and trustees of large equity holders such as pension funds. Therefore, it is reasonable to assume that key cost considerations would be carefully reviewed by these entities. As such, the relatively generous provisions of RBOC OPEB plans would certainly be viewed as a portion of the total labor costs each of these firms was facing.

Although SFAS-106 was not formally adopted until December 1990, the issue of employer liability for OPEBs was raised in 1982 by FASB, stating that such plans were not mere gratuities, but rather a form of deferred compensation.[20] Such a concept implied the notion of accrual accounting. By offering these plans, firms incurred a deferred liability, and should accrue for these costs as they were incurred. As a temporary measure, FASB issued an interim standard in SFAS-81 (Disclosure of Postretirement Health Care and Life Insurance Benefits), which mandated that companies file within their financial reports information covering the benefits provided, the employee groups covered and the accounting and funding aspects of their plans.[21] In February 1989, FASB released a

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[20]Warshawsky, Mark J.,"Retiree Health Benefits: Promises Uncertain?", The American Enterprise, July/August 1991, pp. 56-63.

[21]Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 81: disclosure of Post Retirement Health Care and Life Insurance Benefits, 1984.

proposed version of the accounting standard that would require accrual accounting for OPEB. Then in 1990, the final version was issued. Therefore, for many years, information was available to stock market participants regarding the costs associated with OPEB, and the fact that firms were accruing long-run liabilities for these plans. Also, these same market participants were well aware that FASB was proposing to issue standards requiring such accrual accounting.

In the face of that knowledge, market participants employed that information in determining the price of LEC shares in the stock market. Any negative consequence to earnings or profitability caused by the expectation of SFAS-106 costs was recognized by the market participants and resulted in downward adjustment to the price of the stock (and increasing the implicit yield of the stock) to account for these differences. As the Drazen Affidavit illustrates, statistical evidence has been advanced showing such an effect. Work by Middelstaedt and Warshawsky of the Federal Reserve Board indicates that during the period 1986-88 share prices of those firms that would be affected by SFAS-106 accounting requirements have in fact seen their share prices adjust downward in response to these accounting liabilities.[22] Other discussions have also indicated that share prices have been adjusted to recognize the SFAS-106 liabilities.[23]

[22]Mittelstaedt, H. Fred and Mark Warshawsky, The Impacts of Liabilities for Retiree Health Benefits on Share Prices, No. 156, Finance and Economics Discussion Series, Division of Research and Statistics, Division of Monetary Affairs, Federal Reserve Board, Washington D.C., April 1991.

[23]See, for example, Freudenheim, M. "Costly Accounting Change Planned", The New York Times, September 15, 1989, p. D1.; and , Henriques, D. "Double Whammy - FASB Readies a Blow to Corporate Earnings and Balance Sheets", Barrons, April 17, 1989, p.8.

Somewhat oddly, the LEC-sponsored study by NERA purports to claim that there is virtually no literature that examines the impact of changes in FASB standards to share prices.[24] NERA points to this as demonstrating its otherwise theoretical contention that it is impossible for changes in accounting standards to have impacts on economic activity within the non-regulated sector. Such a contradiction provides further evidence that the attempts by the LECs to have exogenous treatment afforded SFAS-106 costs are not grounded in any concrete analysis.

An argument could be raised that investors would assume that the LECs would be granted regulatory relief for SFAS-106 costs, and therefore their stock prices would remain unaffected. This, however, would be a faulty analysis unless it was provided by LECs to their investors; regulators never indicated that these expenses were allowable. Even under rate of return regulation, interstate cost increases were not given automatic approval. Rather, the Commission routinely disallowed many proposed expenses, and indirectly affected earnings through the adjustment of prospective demand. Because the cost expense adjustments were performed on the basis of statistical tests within the technique of the "report card" tests, individual expenses, such as SFAS-106 could not be shown to be specifically approved. Rather, the general level of expenses was reviewed by the Commission, with no guarantee that LECs could pass along a particular expense. Therefore, had SFAS-106 been instituted during rate of return regulation, investors would still face a risk as to whether carriers would be able to flow through those costs within rates. Also, investors were aware of the Commission's effort to introduce price cap

[24]See, NERA Study, p. 28., Pacific Bell Direct Case, Appendix 1.

regulation on the LECs within a short period of time, and could not have assumed that exogenous treatment of these costs would have been forthcoming for SFAS-106. Moreover, the individual state regulatory schemes would have created additional risk concerning the recovery of the even larger intrastate allocations of SFAS-106 costs. Such uncertainty would require investors to demand a higher level of return than otherwise, increasing the cost of equity and increasing the unitary rate of return.

It is therefore clear that knowledge concerning the costs of SFAS-106 was embedded in share prices prior to the final adaptation of SFAS-106, and the Commission utilized these same share prices to determine the cost of equity for the LECs. Embedded in the 11.25 percent return level is the expectation of SFAS-106 costs and liabilities, and the current attempt to add those costs under price caps would result in double counting. Moreover, even if the Commission determines that some exogenous treatment is justified, such treatment should be strictly limited as explained below.

II. If these cost changes are treated as exogenous,

(a) Should costs associated with implementation of SFAS-106 prior to January 1, 1993 (when the accounting change becomes mandatory) be treated as exogenous?

It is quite clear that costs associated with Generally Accepted Accounting Principles (GAAP) -- if they are actually exogenous -- should not accorded exogenous treatment until they have been approved by FASB, reviewed and approved by the Commission, and they have become effective.[25] Since FASB is not requiring these changes to be made effective until December 16, 1992, any earlier recognition of these changes should be rejected. Allowing LECs to recover amounts from 1992 or earlier calendar years would be tantamount to retroactive ratemaking. The Commission, and access ratepayers, could expect an avalanche of notices, given the opportunity, that LECs were implementing SFAS-106 for 1992 results. Therefore, since SFAS-106 is optional for 1992, and the Commission has already indicated that GAAP changes will not be allowed to drive exogenous cost treatment until its effective date, these LECs should not be allowed any consideration for SFAS-106 costs in 1992.

(c) Given these assumptions, have the individual LECs correctly computed the exogenous cost changes?

At the outset, it must be made clear that there is significant controversy within the accounting profession as to the "correctness" of a methodology to estimate future health care liabilities. Some believe that health care costs will escalate at a level significantly above the current Consumer Price Index, while others believe that health care costs will decelerate from current levels. The whole process of estimating the long-term liabilites is clearly a subjective exercise at best.

MCI has serious concerns with the level of detail provided by the price cap LECs in the computation of their SFAS-106 costs. These concerns primarily address the early stages

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[25] See, American Telephone and Telegraph Company, Trans. No. 2304, 5 FCC Rcd 3680 (AT&T Annual 1990 Price Cap Filing Order); In the Matter of Policy and Rules Concerning Rates for Dominant Carriers Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. at 3187, ¶ 645; and Second Report and Order, CC Docket No. 87-313, ¶ 168; In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Order on Reconsideration, released April 17, 1991, ¶ 63.